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MEMORANDUM FOR THE RECORD

SUBJECT: Conference on LDC Debt Problem

1. On 11 and 12 May, I attended a conference sponsored by Fred Bergsten's Institute for International Economics on the LDC Debt Problem, which was aptly named "The ABM Threat" (the initials standing for Argentina, Brazil, and Mexico). The conference was in two parts: on the evening of 11 May several proposals for dealing with the debt crisis were discussed. On 12 May the discussion concerned the adjustment programs of Argentina, Brazil and Mexico.

Reform Proposals

2. At the 11 May meeting the three speakers were Norman Bailey of the National Security Council, Peter Kennen, Princeton University, and Charles Schumer of the House of Representatives, each of whom presented proposals for dealing with the debt problem. Bill Cline of the Institute for International Economics, was the discussant.

3. Bailey's plan, which has been published and discussed in the press, involves the issuance of Exchange Participation Notes by the central banks of debtor countries, to replace at least part of their debt to private foreign banks. These actions would be taken only by countries judged to be insolvent, with eligibility to be decided by the IMF. Repayment of the notes would be tied to the debtor's foreign exchange earnings. The notes would be marketable, presumably at a discount, but the banks would have the option of holding them. No new institution would be required. Bailey clearly considers his plan to be potentially useful in dealing with the next debt crisis, not the current one. Elsewhere (not at the conference) he has expressed concern that a new recession will begin in 1985-86, before major banks and LDC borrowers have had the time to get their financial situation in order.

4. Kennen agrees that the present ad hoc strategy for dealing with the debt problem may work, but he is concerned that various things may go wrong. For example, OECD economic recovery may be slow because of weak external demand; LDCs may have problems with adjustment programs; banks may be unwilling to provide much additional credit especially if debtors do not fulfill their commitments and regulators force increased write-offs of bad

debts; if the IMF allows debtors to renegotiate many agreements, its credibility may be damaged, and, given the linking of IMF and bank lending, the latter too could be adversely affected. Kennen's plan to deal with the debt problem involves establishing an international Corporation which would discount LDC debt held by private banks. Banks would not be required to deal with the Corporation--in this respect his proposal resembles Bailey's. Only LDC members of the IMF with agreed adjustment programs would be eligible. The discount window would be open only for a limited time, and only once. The Corporation would issue 15-year bonds, carrying a rate of about 1 percent above US government bonds, and which would be marketable. Kennen is ambiguous as to whether or not his proposal should be considered in the near term. He is inclined to give the current ad hoc strategy an opportunity to work, but at the same time would like to do contingency planning in case it doesn't.

5. Congressman Schumer did not present a concrete plan, but rather a list of objectives which he would like to see reflected in legislation. Concerned about the depressive impact of the austerity being forced on the debtor countries on the world economy, he has drafted a bill which instructs the US Representative to the IMF to work for: stretch-out of existing debt; lower interest rates on existing LDC debt; and tying LDC repayments to export earnings. The bill was voted down in committee, but he hopes to get it to the House floor in July.

6. Bill Cline was generally critical of the plans and believes that the current ad hoc strategy has a good chance of working. He is concerned that the implementation of such plans would result in: choking off the flow of bank credit to better-off LDCs; reducing bank capital, and consequently bank lending capability; increasing the requirements for new public capital; and creating moral hazard. If things go badly, he concedes that elements of these plans could be useful but for incorporation in individual reschedulings, rather than as global solutions.

The ABM Adjustment Problem

7. Three questions were addressed in this session with respect to the economic adjustment programs in the ABM countries:

- o What do these adjustment programs entail?
- o Are they on course?
- o What happens if they are not met?

The main speakers were Jose Dagnino Pastore (former Finance Minister of Argentina), Edmar Bacha (Professor at the Catholic University of Rio), and Ariel Buira (a high official in the Bank of Mexico who has been Mexico's principal negotiator with the IMF and the banks). The discussants on the three major countries were Miguel Kiguel (IIE), Rudiger Dornbusch (MIT), Bill Cline (IIE). A more general discussion involved Carlos Alejandro (Yale), Albert Fishlow (Berkeley), Manuel Guitian (IMF), and Anne Krueger (World Bank). The quality of the papers and discussion unfortunately was seriously hampered by the fact that there were press representatives present, the discussion was on the record, and two of the three country speakers felt constrained by their position.

8. On Argentina, Pastore made the following points:

- Argentina's financial problems came earlier than in other countries and the adjustment policies had been in effect for 18 months before the IMF had to be brought in. The Falklands crisis was the trigger for massive capital flight.

- In its negotiations with Argentina, the IMF proved flexible and understanding. The guidelines would permit substantial economic recovery in 1984 and 85.

- Argentina was in compliance with IMF targets in the first quarter and probably will be in the second quarter. As the election approaches, there is likely to be slippage.

- The Argentine experience suggests that long negotiations with the IMF create large uncertainties in financial markets, which are often reflected in the loss of short-term capital. These flows should be better anticipated in setting IMF targets.

- Relations between military government and the civilians who will probably form a new government are reasonably harmonious.

9. According to Professor Bacha, Brazil's IMF program was drawn up hurriedly and is inadequate in a number of respects. Specifically:

- Brazil will probably need $4 billion in additional foreign funds to offset the massive outflow of short-term capital which the IMF program had not anticipated.

- Brazil cannot and should not try to meet its internal financial targets. The target for the Public Sector Deficit was established in nominal terms, on the assumption of a declining rate of inflation, but the PSD is strongly influenced by domestic inflation, and inflation has been accelerating. This was inevitable, given the severe limitations on imports and widespread indexing. Consequently, to meet the target, Brazil would have to force a severe contraction of real GNP (over 15 percent), which no one wants. The IMF analysis was based incorrectly on a savings gap concept rather than on a foreign exchange constraint.

- o Brazil needs to establish a sensible incomes policy with IMF blessing.
- o With the world markets weak and public investments sharply reduced, Brazilian real GNP will fall in any case.
- o Brazil needs a new economic team.

10. Buira portrayed Mexico as a country undergoing a severe economic adjustment and whose government was committed to the IMF program and will give priority to meeting external obligations. Economic activity contracted sharply in the first quarter of 1983:

- o Manufacturing output dropped 11 percent.
- o Employment is down probably 5 percent or more.
- o The fiscal deficit is down.
- o Real interest rates are up.
- o The growth of money supply is declining.
- o The inflation rate is falling.
- o And the trade balance has improved, probably resulting in a surplus on current account.

Mexico can meet external IMF targets and will not need new money. It may not meet all internal targets, but is trying hard and moving strongly in the right direction.

11. Bill Cline believes Buira is too optimistic. If imports continue near recent depressed levels, there will a "savage recession." If they recover, balance of payments targets may not be met and Mexico will need new money. In the medium term, given the lack of indexing, questions must be raised as to the political tolerance to inflation. Buira, however, claims there are no serious political strains; that there is good cooperation from labor.

12. In the general discussion, the following issues were emphasized:

- o The problem of adjusting IMF targets to changing perceptions and conditions without a serious loss of IMF credibility.
- o Related to the above, and to the tendency of smaller banks to pull out their money, how to continue eliciting new "involuntary" lending from large banks which have a big stake in the debtors' stability.

- How to reduce excessive interest spreads, which actually increase when there is a rescheduling, even though the debtor's financial position is thereby eased.

- The risk that effective medium-term adjustment will be sacrificed for the sake of short-term improvements in the trade balance, by means of direct controls.

- Whether import substitution policies in debtor countries adopted to reduce trade deficits are consistent with export promotion.

13. Guitian of the IMF emphasized that targets must be ambitious to give the proper signals, but ceilings should be viewed as instruments, and may have to be modified. It is the thrust of policy, not the specific ceilings, that are important.

Maurice C. Ernst

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